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DOW THEORY LETTERS INC.

"The Market as Interpreted under the Dow Theory"

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THE MARKET: On June 26 the Industrial Average hurdled its preceding (830.17) May 7 peak, thereby entering into all-time high territory. By so doing, the Industrials confirmed the bullish indications of the Rail Average and reconfirmed the primary bull trend.

When this type of action occurred in 1958 and 1959 I used to write long dissertations on the "money-making power" of the great primary trend and the necessity of being fully invested in harmony with a bull market. In view of the long series of new highs in the Averages, why am I so cautious now?

(1) The bull market is very much older today (actually, it is ancient, if we accept June 13, 1949, as the starting point). Furthermore, the current advance began in October, 1962, and has lasted for twenty-one months. This particular leg of the bull market is both old and vulnerable.

(2) Many observers are predicting that the bull market will last into the final quarter of 1964 or the first quarter of 1965. They predict that the Industrial Average will rise to 875-925. In view of the duration and extent of the advance already, we are entitled to be skeptical of these views, but suppose we accept them. Most of the leading Dow Theorists have conceded that one would be extremely lucky if he could buy within 10% of the bottom of a bull market and sell out within 10% of the top. Assuming the final top to be at around 875 to 925 on the Dow, then we are now within 10% of the top. On this basis, the long-term investor should be thinking in terms of "putting his house in order", not of attempting to "beat the market" at this stage of the game.

(3) Since 1957-59, each of the upward legs of the bull market has appeared more labored than the preceding leg. "Tired" markets are

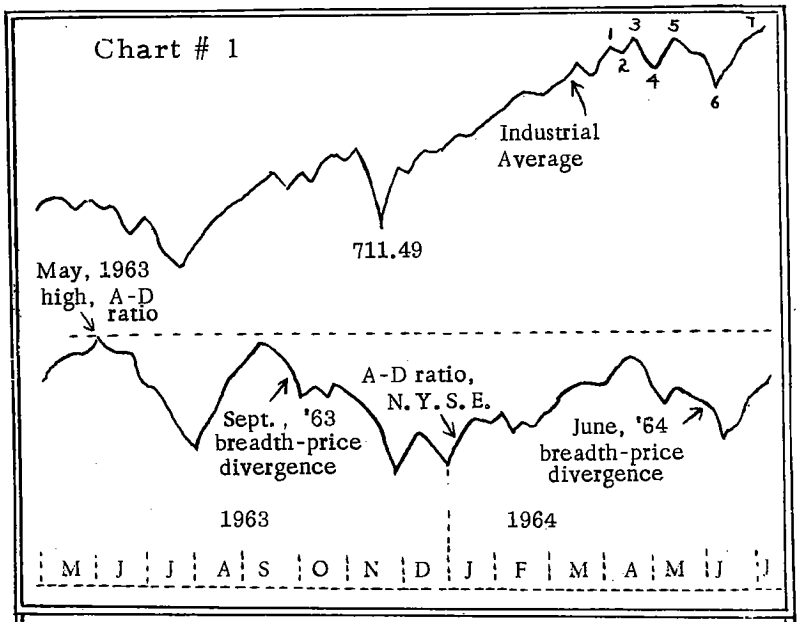
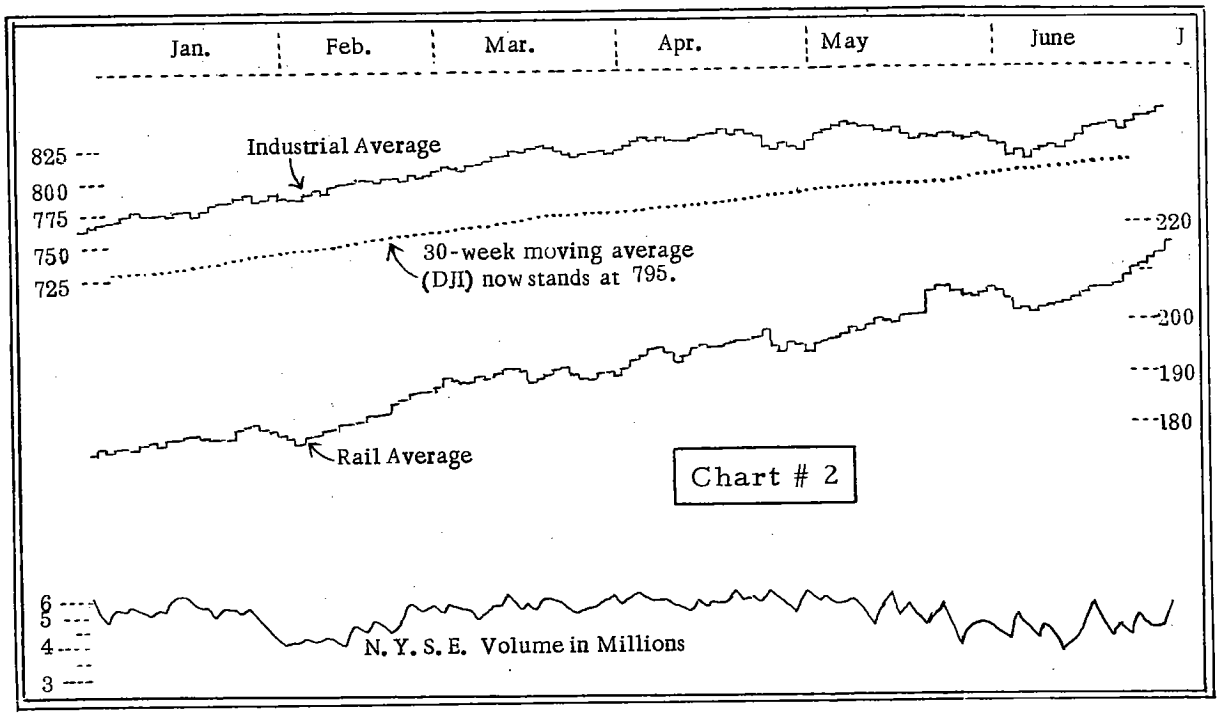


Chart 1: With the bettering of point 5 (830.17) on June 26, the "broadening pattern" which was discussed in Letter 257 has expanded into an extraordinary 6-point reversal structure. The market turned highly speculative on July 1, and Industrials are now pushing against theoretical point 7 in the 830-845 area. The whole Industrial formation appears "frantic" and highly dangerous. On July 1 the advance-decline ratio pushed above the preceding May, 1963, peak and the ratio is now making its third approach to the May, 1963, peak.



difficult markets to make money in; they are usually dangerous as well. In the current affair we note the remarkable spectacle of a peak in the advance-decline ratio in May, 1963, fourteen months ago. We see a peak in General Motors eight months ago. We note that the daily new highs topped out in the first quarter of 1963. Each of these phenomena alone (based on past history) could serve to place the advance on borrowed time.

(4) Economic news is now uniformly bullish. Business and political leaders are forecasting that the expansion will last well into 1965 and even beyond. Some (for instance, the president of Chrysler) are suggesting that major business setbacks are a thing of the past. This type of atmosphere is usually associated with intelligent distribution of stocks — not accumulation.

(5) Primary trends tend to be international in scope, and world markets usually move together. In view of this, it is disconcerting to see foreign markets continuing to decline during 1964. Japan's Average is down 20% from its May, 1963, high. West Germany is 24% below its 1960 peak. France is down 31% from its April, 1962, high. Switzerland is now 37% below its March, 1962, high, and Italy is 44% under its late-1960 high. England alone is within 5% of its 1961 peak.

(6) Following the build-up from July, 1962, to November, 1963, debit balances (margin accounts) have now "flattened out" at a level under their November peak. This type of action (a cessation of a rising trend in total margin accounts) has always been associated with a very selective market. It should be remembered that margin accounts tend to be used by the professional element. On top of this, credit balances (cash left with brokers) have declined steadily during 1964, and this would suggest a gradual entrance of the public into the market (cash into stocks). This again is not a favorable factor.

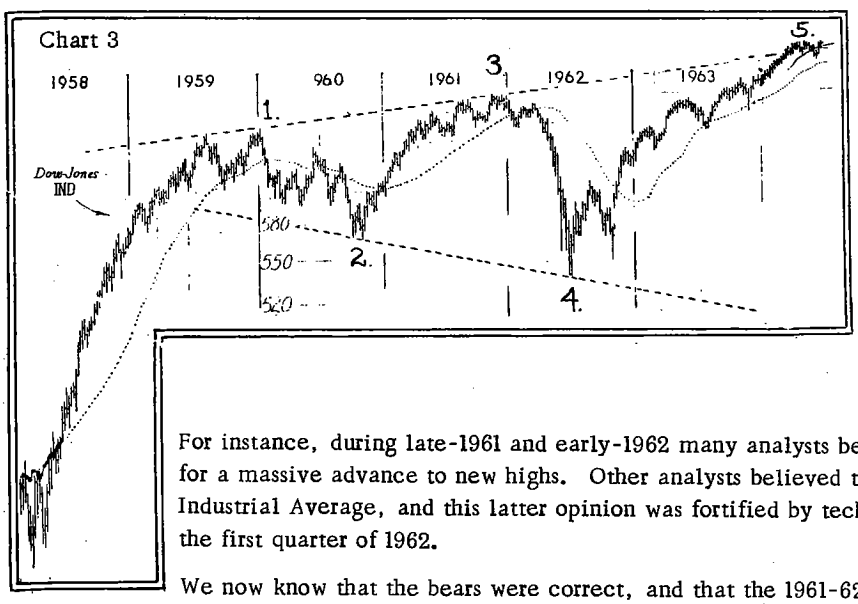
(7) Although the Rail Average has plotted a bullish course since the first quarter, Industrials are still in an extraordinary "broadening pattern" which could be highly dangerous (see Letter 257). Moreover, since the March 18 Industrial peak (820.25), about 360 million shares have changed hands but the senior Average has gained less than 3%. This suggests "churning" and distribution.

In the light of all the foregoing observations, I have preferred to remain cautious in the face of the successive new highs in the Industrial and Rail Averages. I have remained cautious in the use of my own funds during 1964; how can I advise my subscribers to do differently?

ON THE TRENDLINE: When watching the daily action, one is often moved to conclude that the market is a senseless, formless conglomeration of disparate stock movements. But the daily movements can easily obscure the big picture. The historian, George W. Cable, once wrote: "What we call chance may be the operation of a law so vast that we only touch its orbit once or twice in a lifetime." Cable's words came to mind last week as I studied the extraordinary pattern which has been traced by the Industrial Average over the past five years (Chart 3). One wonders, as one studies Chart 3, whether there is not some "master plan" or overall pattern which the stock market is faithfully following. It is hard to believe that the action on that chart could be simply a matter of coincidence or blind chance.

Dow's Theory goes only so far as to state that there are definite tides in human affairs, and that these tidal forces are reflected in the primary movements of the stock market. According to Dow's Theory, once a bull market starts, the Averages rise and continue to rise until the best that can be foreseen is fully discounted in the price structure. Conversely, when a bear market is in effect the Averages decline until the worst that can be seen ahead is fully discounted by the market.

The classification and recognition of this underlying (primary) trend is the most important task to face the investor. The second most important task is to try to fathom the form or pattern which the primary movement is apt to take.



Back in 1959, no one envisioned the incredible pattern which the Industrial Average was to follow over the next five years (Chart 3). In fact, if anyone had suggested in December, 1959, that the market was on the threshold of the first of four major reversals which would stretch out into 1964, he would have been labeled a perfect fool. Yet, this is exactly what occurred.

Technical analysis is made up of two parts: (1) pattern or form, and (2) underlying technical condition or market psychology. The technical condition of the market provides the analyst with knowledge or ammunition from which he may infer that this or that pattern is liable to materialize. For instance, during late-1961 and early-1962 many analysts believed that the Industrial Average was consolidating for a massive advance to new highs. Other analysts believed that a "head-and-shoulders top" was forming in the Industrial Average, and this latter opinion was fortified by technical weakness which appeared in the market during the first quarter of 1962.

We now know that the bears were correct, and that the 1961-62 action was part of a head-and-shoulders top — not a consolidation move preparatory to new highs. It was the poor technical condition of the market which lent

credence to the "top" theory, the theory which ultimately proved to be the correct one.

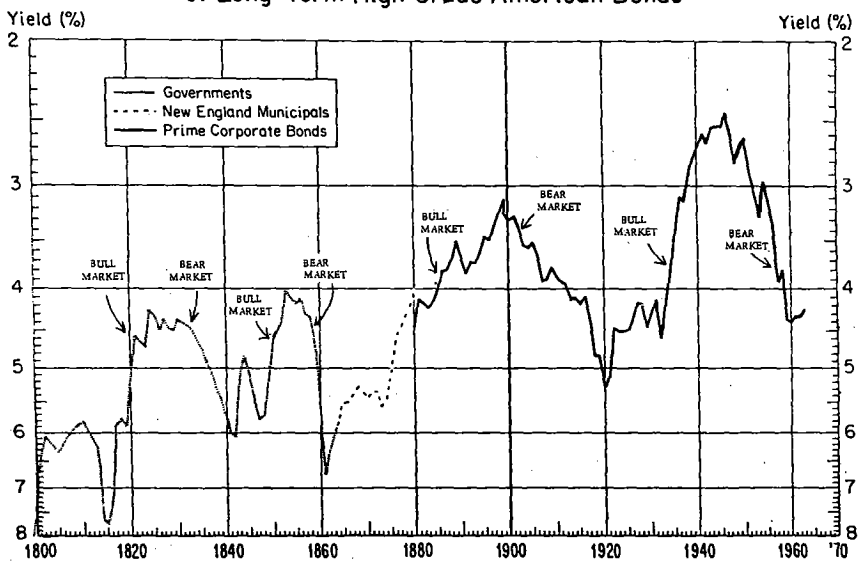
Referring again to the chart (page 2), it is a fact that following point 4, many analysts believed that a massive head-and-shoulders pattern (encompassing the entire 1959-63 price structure) was developing. This theory was obviously incorrect, and instead the Industrial Average has advanced to the point where it is now moving along the upper trendline (point 5) of what could be a giant "broadening pattern" (see Letter 256).

The question immediately arises: "Couldn't this whole broadening concept be a product of the analyst's constant desire to bring order out of chaos? Answer: Yes, admittedly the broadening concept presented in Chart 3 could well be an analyst's pipe dream. Yet, one wonders if it could be coincidence that the Industrial Average touched the upper trendline (and then turned down) once in 1959, once in 1960, and twice again in 1961. It is also notable that in the current situation the Industrial Average has fluctuated slightly above or below the same trendline during the past sixteen weeks. To my mind, the fact that the Industrial Average has made contact with the upper trendline on five separate occasions during the past five years lends credence to the whole concept of the broadening formation. The potential power in this huge broadening structure is one of the things which lends an exciting aspect to the market at this time.

BONDS: Letter 249 contained a discussion of the U. S. Treasury bond market. At that time I noted that the U. S. Government alone has $208 billions of bonds, notes and bills outstanding (not counting savings bonds). If to this, we add the hundreds of billions in corporate, city, municipal and state debt we obtain some idea of the vastness of the total U. S. debt structure.

One thing is certain about debt, and that is that through good times and bad — it must be serviced (i. e., interest on the debt must be paid). This may well be one of the most important facts facing the entire nation over the next few years.

Inverted Yields
of Long-Term High Grade American Bonds



Many investors give a passing glance to the daily bond averages, but few are aware of the "big picture" in money. Just as the stock market passes through major bull and bear phases, so the bond market too enters extended periods of advance or decline. But the major bull and bear markets in bonds seem to consume very much more time than is the case in the stock market. One of the convenient ways of measuring bond swings is via the bond yield cycles, and the accompanying chart follows bond yields over a 165-year period.

During the ninteenth century, bull and bear markets in stocks tended to last one to three years (as those who have read Dow's original works know). But even then, the major swings in the bond market tended to last a good deal longer than the stock market swings. For instance, an eleven year bull market in bonds occurred between 1799 and 1810. A bear market in bonds carried from 1810 to 1815. A ten-year bull market extended to 1825, and the subsequent seventeen-year bear market in bonds lasted to 1842. A new bull market carried to 1853 and a bear market was concluded in 1861.

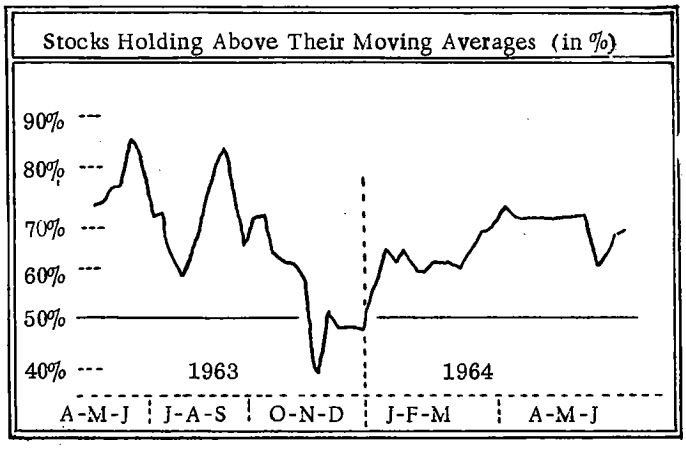
From the time of the Civil War to the present the bond movements were characterized by even more massive and prolonged swings. A forty-year bull market in bonds carried from roughly 1860 to 1900. A twenty-six year bear market lasted into 1920, and a subsequent bull market touched its peak in 1946. A major bear market in bonds started in 1946, and nothing on this chart suggests that the bear market has terminated.

Nevertheless, the chart shows that interest rates did record a high in 1959, and since then they have followed a minor declining trend. This has prompted some observers to state that the major bear market in bonds may have ended (as is currently suggested in the Financial Analysts Journal — see article by Sidney Homer).

An important test for the bond market may soon be upon us, and the pressure for the test will probably stem from abroad. The following is from economist Eliot Janeway's recent report: "Money rates all through Europe are high and going higher. We expect to see decidedly higher interest rates over there — including Britain. Herewith a preliminary warning to avoid fixed ideas about how Harold Wilson will govern England if he wins the election set for next October. We expect that even he will go along with the universal European trend towards higher interest rates."

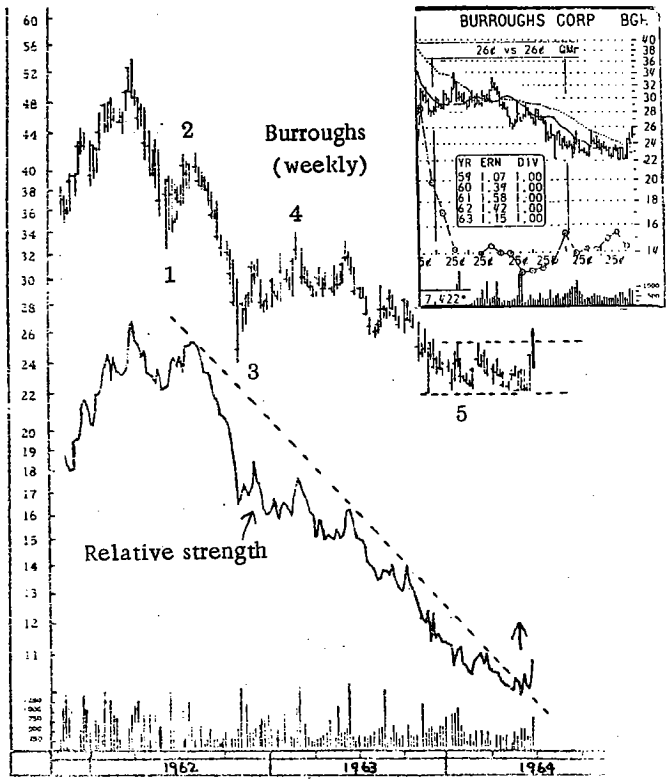
Mr. Janeway is more optimistic than I am regarding the outlook for U.S. interest rates in the face of the deepening financial crisis in Europe. He continues: "It's a sorry outlook for bond markets in Europe. But we do not expect interest rates here to follow in the

wake of interest rates there. On the contrary, the outlook here is for more of the same — no upward pressure on interest rates, and a bond market that continues strong despite business improvement." There it is, and the test is probably close at hand.

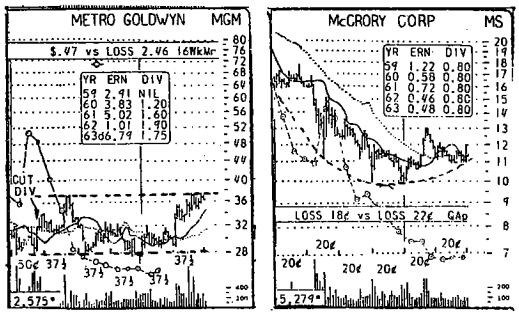


STOCKS: Of 431 representative stocks which are tabulated here weekly, 290 (67%) are now holding above their long-term or 200-day moving averages. This is a rise of 1% from last week and well above the critical 50% level. As long as we are above 50%, this study remains bullish (see chart).

Market strength has been extremely selective, and the greatest care must be given to the picking of speculative candidates. In the last Letter I recommended two stocks for speculative purchases, Burroughs and MGM. Their action last week was so interesting that they are worth reviewing again. On July 1, MGM pushed to the top of its rectangle formation. A "breakout" to about 39 would appear very bullish for this stock (see chart) and would put MGM in position to be a speculative leader on any further market strength. The "measurement" of the upside potential on a rectangle breakout is a further advance (taken from the point of breakout) equal to the height of the rectangle. This would put MGM in line for a potential move to about 50.



On June 30, Burroughs rose a whopping 10%, pushing above the base-like rectangle pattern which has contained the stock for the past 7 months. The breakout was accompanied by heavy volume and a definite reversal to the upside in the stock's relative strength. One point of particular interest in BGH is the fact that the collapse since the 1962 high has taken the form of five distinct legs (as marked on chart). This 5-leg pattern is often associated with the completion of a major movement in a stock and it is, for instance, the formation which appeared in the Bucyrus-Erie decline. While such observations are, of course, strictly theoretical, it is possible that BGH has completed a major bear market of its own and is now ready to embark on a new bull phase. At worst, last week's breakout from point 5 suggests that a major (upward) correction in BGH is now underway. If such a correction succeeds in retracing only half of the ground lost since the 1962 high, it could take BGH to the 38 area. I continue to view purchases in BGH as an intelligent speculation in a stock which is outperforming the market after a collapse in relative strength.



One of the most depressed groups on the Board is the retail variety chains. This group touched its peak of relative strength (popularity) in 1935, and it has been dropping in relative strength ever since. The group touched a low in R. S. in March of 1964, but since then it has edged up. This month the variety chains touched their highest relative strength level in a year. While this may not be a major turn, it is well to remember that many of the great moves (i.e., Chrysler) have come from groups or stocks which have collapsed in R. S. and then become popular again.

McCrory in the variety chain group was recommended in Letter 250. This low-priced stock bounced off the 11 area in 1953, 1958 and 1960. It has recently found support in the 10-11 area, and it now appears to be moving out of a "rounding bottom" pattern. The 200-day moving average (see chart) on MS stands at 11 1/2. The stock can be bought as a speculation here with the stipulation that it be sold (1) if it breaks under 11, or (2) if it breaks under 10, the level that held this stock during the past 15 years.

(The writer wishes to state that he has a small position in the common stock of Burroughs).

Large chart of BGH courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois, 62003. Small chart of BGH, MS and MGM and chart # 3 courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas.